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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9598]

RIN 1545-BK98

Integrated Hedging Transactions of Qualifying Debt

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations that address certain integrated transactions that involve a foreign currency denominated debt instrument and multiple associated hedging transactions. The regulations provide that if a taxpayer has identified multiple hedges as being part of a qualified hedging transaction, and the taxpayer has terminated at least one but less than all of the hedges (including a portion of one or more of the hedges), the taxpayer must treat the remaining hedges as having been sold for fair market value on the date of disposition of the terminated hedge. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date. These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date. These regulations apply to leg-outs within the meaning of §1.988-5(a)(6)(ii) which occur on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Sheila Ramaswamy, at (202) 622-3870
(not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 1.988-5 provides detailed rules that permit the integration of a qualifying debt instrument with a §1.988-5(a) hedge. The effect of integration under the regulations is to create a synthetic debt instrument. Generally, if a taxpayer enters into a qualified hedging transaction and meets the requirements of the regulations, no exchange gain or loss is recognized on the debt instrument or the hedge for the period that it is part of a qualified hedging transaction (provided that the synthetic debt instrument is not denominated in a nonfunctional currency). See §1.988-5(a)(9). A qualified hedging transaction is an integrated economic transaction consisting of a qualifying debt instrument and a §1.988-5(a) hedge. See §1.988-5(a)(1). A qualifying debt instrument is any debt instrument described in §1.988-1(a)(2)(i) regardless of its denominated currency. See §1.988-5(a)(3). A §1.988-5(a) hedge is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, or similar financial instrument, or series or combinations of such instruments, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity in the currency in which the synthetic debt instrument is denominated. See §1.988-5(a)(4).

Under §1.988-5(a)(6)(ii), a taxpayer that disposes of all or a part of the qualifying debt instrument or hedge prior to the maturity of the qualified hedging transaction, or that changes a material term of the qualifying debt instrument or hedge, is viewed as “legging out” of integrated treatment. One of the consequences of legging out is that if the hedge is disposed of, the qualifying debt instrument is treated as sold for its fair

market value on the date of disposition of the hedge (leg-out date). See §1.988-5(a)(6)(ii)(B). Any gain or loss on the qualifying debt instrument from the date of identification to the leg-out date is recognized on the leg-out date. The intended result of this deemed disposition rule is that the gain or loss on the qualifying debt instrument will generally be offset by the gain or loss on the hedge.

The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) have become aware that some taxpayers who are in a loss position with respect to a qualifying debt instrument that is part of a qualified hedging transaction are interpreting the legging-out rules of §1.988-5(a)(6)(ii)(B) to permit the recognition of the loss on the debt instrument without recognition of all of the corresponding gain on the hedging component of the transaction. Taxpayers claim to achieve this result by hedging nonfunctional currency debt instruments with multiple financial instruments and selectively disposing of less than all of these positions. Taxpayers take the position that §1.988-5(a)(6)(ii)(B) triggers the entire loss in the qualifying debt instrument but not the gain in the remaining components of the hedging side of the integrated transaction.

For example, a taxpayer may fully hedge a fixed rate nonfunctional currency denominated debt instrument that it has issued with two swaps--a nonfunctional currency/dollar currency swap and a fixed for floating dollar interest rate swap. The effect of matching the currency swap with the foreign currency denominated debt is to create synthetic fixed rate U.S. dollar debt while the effect of the interest rate swap is to simultaneously transform the synthetic fixed rate U.S. dollar debt into synthetic floating rate U.S. dollar debt. Thus, assuming that the rules of §1.988-5(a) are otherwise satisfied, the taxpayer will have effectively converted the fixed rate foreign currency denominated debt instrument into a synthetic floating rate U.S. dollar denominated debt

instrument.

As the U.S. dollar declines in value relative to the foreign currency in which the debt instrument is denominated, the taxpayer disposes of the interest rate swap while keeping the currency swap in existence. The taxpayer takes the position that the disposition of the interest rate swap allows it to treat the debt instrument as having been terminated on the date of disposition and claims a loss on the debt instrument without taking into account the offsetting gain on the remaining component of the hedge. Thus, the taxpayer claims the transaction generates a net loss. The IRS and the Treasury Department believe that these results are inappropriate under the legging-out rules since the claimed loss is largely offset by unrealized gain on the remaining component of the hedging transaction. Therefore, the IRS and the Treasury Department are issuing these regulations to clarify the rules regarding the consequences of legging-out of qualified hedging transactions that consist of multiple components. No inference is intended regarding the merits of the position taken by the taxpayer with respect to the transaction described above (or comparable positions taken by taxpayers with respect to similar transactions) in the case of transactions occurring prior to the applicability date of these regulations, and in appropriate cases the IRS may challenge the claimed results.

Explanation of Provisions

Section 1.988-5(a) is amended to provide that if a hedge with more than one component has been properly identified as being part of a qualified hedging transaction, and at least one but not all of the components of the hedge that is a part of the qualified hedging transaction has been terminated or disposed of, all of the remaining components of the hedge (as well as the qualifying debt) shall be treated as sold for their fair market value on the leg-out date of the terminated hedge. Similarly, if a part of

any component of a hedge (whether a hedge consists of a single or multiple components) has been disposed of, the remaining part of that component (as well as other components in the case of a hedge with multiple components) that is still in existence (as well as the qualifying debt instrument) shall be treated as sold for its fair market value on the leg-out date of the terminated hedge.

Effective/Applicability Date

The regulation applies to leg-outs within the meaning of §1.988-5(a)(6)(ii) which occur on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Sheila Ramaswamy, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.988-5 is amended by:

1. Revising paragraph (a)(6)(ii).
2. Adding Example 11 in paragraph (a)(9)(iv).

The revision and addition read as follows:

§1.988-5 Section 988(d) hedging transactions.

(a) * * *

(6) * * *

(ii) [Reserved]. For further guidance see §1.988-5T(a)(6)(ii).

* * * * *

(9) * * *

(iv) * * *

Example 11. [Reserved]. For further guidance see §1.988-5T(a)(9)(iv).

Example 11.

* * * * *

Par. 3. Section 1.988-5T is added to read as follows:

§1.988-5T Section 988(d) hedging transactions (temporary).

(a) through (a)(6)(i) [Reserved]. For further guidance see §1.988-5(a) through (a)(6)(i).

(ii) Legging out. With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, “legging out” of integrated

treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or any portion of the qualifying debt instrument or the hedge prior to maturity of the qualified hedging transaction, or the taxpayer changes a material term of the qualifying debt instrument (for example, exercises an option to change the interest rate or index, or the maturity date) or the hedge (for example, changes the interest or exchange rates underlying the hedge, or the expiration date) prior to maturity of the qualified hedging transaction. A taxpayer that disposes of or terminates a qualified hedging transaction (that is, disposes of or terminates both the qualifying debt instrument and the hedge in their entirety on the same day) shall be considered to have disposed of or otherwise terminated the synthetic debt instrument rather than legging out. If a taxpayer legs out of integrated treatment, the following rules shall apply:

(A) The transaction will be treated as a qualified hedging transaction during the time the requirements of this paragraph (a) were satisfied.

(B) If all of the instruments comprising the hedge (each such instrument, a component) are disposed of or otherwise terminated, the qualifying debt instrument shall be treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated (the leg-out date), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment must be made to reflect any gain or loss taken into account. The netting rule of §1.988-2(b)(8) shall apply.

(C) If a hedge has more than one component (and such components have been

properly identified as being part of the qualified hedging transaction) and at least one but not all of the components that comprise the hedge has been disposed of or otherwise terminated, or if part of any component of the hedge has been terminated (whether a hedge consists of a single or multiple components), the date such component (or part thereof) is disposed of or terminated shall be considered the leg-out date and the qualifying debt instrument shall be treated as sold for its fair market value in accordance with the rules of paragraph (a)(6)(ii)(B) of this section on such leg-out date. In addition, all of the remaining components (or parts thereof) that have not been disposed of or otherwise terminated shall be treated as sold for their fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date shall be used to determine exchange gain or loss on the remaining components (or parts thereof) for the period beginning on the leg-out date and ending on the date such components (or parts thereof) are disposed of or otherwise terminated.

(D) If the qualifying debt instrument is disposed of or otherwise terminated in whole or in part, the date of such disposition or termination shall be considered the leg-out date. Accordingly, the hedge (including all components making up the hedge in their entirety) that is part of the qualified hedging transaction shall be treated as sold for its fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date shall be used to determine exchange gain or loss on the hedge (including all components thereof) for the period beginning on the leg-out date and ending on the date such hedge is disposed of or otherwise terminated.

(E) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the part of the qualified hedging transaction that

has not been terminated (that is, the remaining debt instrument in its entirety even if partially hedged, or the remaining components of the hedge) cannot be part of a qualified hedging transaction for any period subsequent to the leg-out date.

(F) If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the disposed of or terminated debt instrument or hedge, then paragraph (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that, taken together with any remaining components of the hedge, hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction or, if appropriate, an equivalent amount under the hedge (or any remaining components thereof) that was part of the qualified hedging transaction. Similarly, in a case in which a hedge has multiple components that are part of a qualified hedging transaction, if the taxpayer legs out of a qualified hedging transaction by terminating one such component or a part of one or more such components and realizes a gain with respect to the terminated component, components, or portions thereof, then paragraphs (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if the remaining components of the hedge (including parts thereof) by themselves hedge at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction.

(a)(7) through (a)(9)(iv) Examples 10 [Reserved]. For further guidance see §1.988-5(a)(7) through (a)(9)(iv) Example 10.

Example 11. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 2013, K borrows 100 British pounds (£) for two years at a 10% rate of interest payable on December 31 of each year with no principal payment due until maturity on December 31, 2014. Assume that the spot rate on January 1, 2013, is £1=\$1. On the same date, K enters into two swap contracts with an unrelated counterparty that economically results in the transformation of the fixed rate £100

borrowing to a floating rate dollar borrowing. The terms of the swaps are as follows:

(A) Swap #1, Currency swap. On January 1, 2013, K will exchange £100 for \$100.

(1) On December 31 of both 2013 and 2014, K will exchange \$8 for £10;

(2) On December 31, 2014, K will exchange \$100 for £100.

(B) Swap #2, Interest rate swap. On December 31 of both 2013 and 2014, K will pay LIBOR times a notional principal amount of \$100 and will receive 8% times the same \$100 notional principal amount.

(ii) Assume that K properly identifies the pound borrowing and the swap contracts as a qualified hedging transaction as provided in paragraph (a)(8) of this section and that the other relevant requirements of paragraph (a) of this section are satisfied.

(iii) Assume also that on January 1, 2014, the spot exchange rate is £1:\$2; the U.S. dollar LIBOR rate of interest is 9%; and the market value of K's note in pounds has not changed. K terminates swap #2. K will incur a loss of (\$.91) (the present value of \$1) with respect to the termination of such swap on January 1, 2014. Pursuant to paragraph (a)(6)(ii)(C) of this section, K must treat swap #1 as having been sold for its fair market value on the leg-out date, which is the date swap #2 is terminated. K must realize and recognize gain of \$100.92 [the present value of £110 discounted in pounds to equal £100 x \$2 (\$200) less the present value of \$108 (\$99.08)]. The loss inherent in the pound borrowing from January 1, 2013 to January 1, 2014 is realized and recognized on January 1, 2014. Such loss is exchange loss in the amount of \$100 [the present value of £110 that was to be paid at the end of the year discounted at pound interest rates to equal £100 times the change in exchange rates: (£100 x \$1, the spot rate on January 1, 2013) - (£100 x \$2, the spot rate on January 1, 2014)]. Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the pound borrowing and currency swap cannot be part of a qualified hedging transaction for any period subsequent to the leg-out date.

(iv) Assume the facts are the same as in paragraph (iii) of this section except that on January 1, 2014, the U.S. dollar LIBOR rate of interest is 7% rather than 9%. When K terminates swap #2, K will realize gain of \$0.93 (the present value of \$1) received with respect to the termination on January 1, 2014. Fifty percent or more of the remaining pound cash flow of the pound borrowing remains hedged after the termination of swap #2. Accordingly, under paragraph (a)(6)(ii)(F) of this section, paragraphs (a)(6)(ii)(B) and (C) of this section do not apply and the gain on swap #1 and the loss on the qualifying debt instrument is not taken into account. Thus, K will include in income \$0.93 realized from termination of swap #2.

(a)(10) through (g) [Reserved]. For further guidance see §1.988-5(a)(10) through (g).

(h) Effective/applicability date. This section applies to leg-outs that occur on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

(i) Expiration date. This section expires on September 4, 2012.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved: August 17, 2012.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

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